The ongoing problem of "too much" or "too little" money is as old as the country itself. A healthy economy needs a money supply growing in a way that promotes economic growth and high employment without inflation.

AMERICAN History
Today's Homework
Read: Ch 7-9
Pp 125-132
D2-24 Q 18, 19, 26-29
I’d like to, Mr. Allen, but I’ve got to do a paper for my economics course.

Me, too! We’re studying the Federal Reserve System.

Dad, I told you I have to write a report on it.

There’s certainly a lot to write about. I teach about the Federal Reserve in my history course. Maybe I can help.

Okay.

But it better be quick.

Wow, that was a super movie, Mr. Allen.

Yeah! Thanks for taking us, Dad.

My pleasure, guys! Let’s go for a soda!
Well, we're studying how and why the Federal Reserve System developed.

...and just what its role is in our economy!

Hmm... well, that's quite a story. Actually, it goes all the way back to Colonial America... before the revolution.

Too bad we don't have a time machine like the one we saw in the movie.

Say, that's not a bad idea! Let's imagine our booth is a time machine! We could go back in time and see how it all began.

All right. We're sitting in the time machine... here's the control panel!

Yeah! Look at all those diats!
Okay... we'll go back to Colonial times, before the revolution!

Ready, gang? I'm going to push the lever and send us back to 1690!

We're ready!

Hey... the sun and moon are zipping across the sky backwards!
Now it's 1760. That's before the Revolution.

We're hovering over a clearing. The dial says it's 1690.

I wonder where we are?

This is like being in a flying saucer. Won't we scare them?

No...we can see them, but they can't see us.

Yes, and we're beginning to slow down!

Probably somewhere over Virginia. I see people down there. Let's see what's going on.
The early colonists occasionally used the coin or currency of other nations, such as “pieces of eight” or “Spanish dollars.” But barter was more usual, and it seriously limited the amount of economic activity that could take place.

“Finding a trader who wants what you have can be very difficult. For example, if you can’t find someone interested and you have food to trade, it might spoil; and if you’re trading cows, how do you make change?”

Did they move from barter right into today’s money?

No. Money started to develop when people began to find that using such things as tobacco and animal skins as a medium of exchange didn’t work very well.

Why not?

Well, suppose people were using tobacco as money, and the usual rate was 5 bales of tobacco for one plow. What do you think would happen if there was a huge tobacco harvest?
"So there was always a danger in using a commodity as money because its supply could change suddenly."

WELCOME TO NEW CONTINENT TRADING POST

PLOWS @ 10½ BALES TOBACCO

Let's see! With lots of tobacco, that means there'd be lots of money...

...and lots of spending with people buying up as much as they could. I guess that would cause prices to skyrocket.

What about this? Why didn't they use this stuff?

They did—occasionally. When goods were sold to foreigners, they paid with their own monies. Remember that rare coin that Aunt Clara has?

Sure, dad! That's a beautiful old coin!

Why didn't the colonists produce their own money, Mr. Allen?

Let's stop and see what it was like in 1776.

Okay!
The war has started!

Yes...and the new government has the problem of financing the war.

How could it without enough money, Mr. Allen?

Well, it wasn’t easy... The Continental Congress could not collect taxes. The thirteen colonies reserved that right, so the Congress borrowed money, especially from the French and Dutch.

The Continental Congress authorized the printing of paper money, called “ Continentals.”

Look! There’s a battle going on down there!

I bet that’s Bunker Hill!

Alright! The surrender at Yorktown!

The war’s over, Mr. Allen!

Yes, but it was very costly in lives and money! The government issued excessive amounts of Continentals, causing a sharp inflation. By 1779, a continental was worth only two cents!... “Not worth a continental” was the expression of the day.
The mint coined gold and silver, which established a bimetallic standard.

The Bank of the United States issued paper currency backed by gold and silver.

All of that should've solved the money problem!
“At first it worked. But a few years later the market price of silver dropped because so much was mined, and as the value of silver dropped, it bought fewer commodities, including gold.”

With only silver in circulation, and silver buying less, there was too little money and the economy contracted.

It certainly was a problem to find the right balance between “too little” and “too much.”

The less valuable silver coins were increasingly used and the more valuable gold was driven from circulation.

That’s Gresham’s Law!

Maintaining a healthy economy without causing inflation or recession is still the most difficult problem monetary authorities have to deal with.

What about the First Bank of the United States? Wasn’t there anything it could do to solve the problem?

The bank was a step in the right direction.
The Bank held gold and silver deposits, and issued bank notes when it made loans... But the Bank's charter expired in 1811.

"Banks were starting to pop up all over the place as they took over the issuance of money."

"We're in the middle of the War of 1812!"

Hey! Look out! Bombs are bursting all around us!

We almost got hit by a rocket!

That's Fort McHenry down there being bombarded by the British fleet!

I wonder if Francis Scott Key is down there writing the Star Spangled Banner?

Another war, how tragic! And as wars usually do, the War of 1812 had a tremendous effect on the economy.
"Yes, it was! It restored confidence in banks by being very strict about gold and silver reserves. When the Second Bank collected tax payments for the government, it accepted only bank notes that could be exchanged for gold and silver."

"Right! And some banks issued more notes than were backed by their gold and silver reserves. With wartime shortages and too much money, prices took off. By the end of the war, the economy and the banking system were near collapse."

"The borrowing needs of the Federal government to finance the war once more spurred the growth of state chartered banks. I guess bank notes were coming out of the woodwork!"

"In an effort to restore confidence in the banking system, Congress, in 1816, issued a 20-year charter to the Second Bank of the United States. That seems like a good move."

"And this solved the over-issuance problem? To a large extent."
President Andrew Jackson supported that argument and the Second Bank’s charter expired in 1836.

He pulled the Federal government’s funds from the Second Bank and deposited them in several favored, or pet, banks. Without the Second Bank, states were the sole charterers of banks.

“And so did the number of notes they issued. Some had insufficient gold and silver reserves to back them.”

Wasn’t this the era of “free banking,” Mr. Allen?

Yes, the number of state banks exploded.

“President Andrew Jackson supported that argument and the Second Bank’s charter expired in 1836.”
They're firing on Fort Sumter. It's 1861 and the Civil War is starting.

Another war! That will shake up the economy!

No, the government wouldn't accept them. It had just set up nationally chartered banks to achieve a uniform currency. They issued different notes called "greenbacks" that were not redeemable in gold or silver. Banks used them to pay for the bonds.

"It sure did! The government couldn't pay for the war with taxes alone. It had to borrow by selling bonds to state chartered banks."

So the banks paid with bank notes?

No, the government wouldn't accept them. It had just set up nationally chartered banks to achieve a uniform currency. They issued different notes called "greenbacks" that were not redeemable in gold or silver. Banks used them to pay for the bonds.

Looks like the Federal government was regulating banking and money again.

You could say that, "Greenbacks" were declared legal tender for all, public and private debts.
After the Civil War, the Treasury reduced its debt by calling in greenbacks. Prices declined while the economy slowed.

Some took their customers' gold and silver coins and greenbacks, and issued a new type of money called 'checkbook money' which customers could spend.

Farmers and small businesses were in a pinch. They lost customers for their goods.
The greenback party wanted more paper money, right, Mr. Allen?

Right!

...and the populists were pushing for more gold and silver coinage.

I guess they thought these actions would stimulate the economy.

Exactly. The populists won a partial victory with legislation that caused more silver coin to be minted.

But what happened, Mr. Allen? I've read that in 1900, the country went on the gold standard.

True, but because of some new large gold discoveries, gold prices fell sharply and silver was hoarded.

Here comes Gresham's Law again!

Yep! The U.S. moved to a gold standard which Europe already had.

What about paper notes?

"They were still around and you could exchange them for gold coin. The more gold a country had, the more notes it could have because paper money was backed by gold."
It sure did! When we lost gold, people rushed to their banks to get their money. Banks failed, the economy suffered and panic developed. International gold flows helped trigger a severe banking panic in 1907.

"The panic shocked Congress into studying the banking and economic systems. This resulted in the Federal Reserve Act, which President Wilson signed into law in 1913."
Well, gang, let's get our time machine back to the present!

I'm ready!

Me, too!

Okay, I've set the time and date. Hold on, here we...

Goooooooollllllllllll!

Wow, that was a great trip! Thanks a lot, Mr. Allen!

I enjoyed it, too. But now we'd better get going. You've got to get those reports done!

It'll be easy now! I never knew homework could be such a trip!
Governors are appointed by the President, with Senate approval, for a fourteen-year term. That insulates their decisions from day-to-day political pressures. And reserve bank presidents participate with the governors in important policy decisions.
The Fed gets its revenue from the interest it earns on government securities it owns. It is not funded by Congress.

So that must give the Federal Reserve some independence.

Just how does the Federal Reserve control money?

Today, the Federal Reserve influences money creation by controlling bank reserves.

They are cash in banks’ vaults and banks’ required balances at Federal Reserve banks.

"Most of today’s money is in the form of deposits — like the checking accounts folks have."

And the rest of it is this.

So the economy runs smoothly now?

Certainly better than before.
"As you history students know, there were some very difficult economic times since the Fed was established, such as the Great Depression of the 1930's and various wars. These times simply overwhelmed the Federal Reserve System's ability to keep the economy running smoothly. However, monetary policy is far better able to cope with economic difficulties now than before.

"By constantly adjusting reserves, the Federal Reserve strives to sustain a robust economy with full employment without inflation."
The job of the Fed is to try to adjust reserves so that neither "too much" nor "too little" money is created.

Similarly, the Federal government, through its taxing, spending, and borrowing, also seeks the same goals as the Federal Reserve—to have the economy grow with stable prices and full employment.